

We also find the testimony of Pacific's witness Hamilton unpersuasive in claiming that CLECs incur lower traffic-sensitive switching costs as a result of trunk-to-trunk switching. On cross-examination, Hamilton admitted he did not know what a traffic-sensitive versus non-traffic sensitive cost is.⁵⁴ Pacific's counsel stipulated that Hamilton's testimony only addressed differences in network functions, but made no representation concerning traffic-sensitive versus non-traffic sensitive costs.⁵⁵ Yet, since only traffic-sensitive cost reductions are relevant to reciprocal compensation, we can draw no inferences from Hamilton's testimony concerning lower CLEC switching costs as they relate to reciprocal compensation.

As ICG witness Starkey testified, traffic-sensitive switch processor and switching fabric costs are incurred for inbound calls terminated to ISDN-PRI trunks. Whether traffic is provided over a trunk facility or a line facility, the job of the switch in terms of mapping calls to their predetermined destination points remains the same. While certain specific switch components may differ between trunk and line switching, the two primary traffic-sensitive cost drivers within a switch (i.e., capacity--switch fabric costs measured in time slot availability, and processing time, measured in milliseconds) remains the same.⁵⁶

Verizon witness conceded that the per-call set up cost for the PRI configuration used for ISP traffic is actually slightly higher because more processing time is required, but argues that the higher cost is outweighed by the longer holding times associated with ISP traffic.⁵⁷ Yet, as we have noted above, the

⁵⁴ Tr. at 1568-69 (Pacific/Hamilton).

⁵⁵ Tr. at 1582 (Pacific/Disher).

⁵⁶ Exh. 2 (ICB/Starkey) at 13.

⁵⁷ Exh. 154 (Verizon/Collins) at 8.

proper way to correct for the longer holding times is to disaggregate the reciprocal compensation rate to allow for separate fixed charges for set up costs. By making this correction in the rate, there would be no overstatement of costs due to long holding times. On this basis, Verizon's testimony supports a finding that traffic-sensitive set-up costs are actually higher for ISP traffic. In any event, the ISP call set-up charge is no less than for voice traffic.

We find the testimony of ICG witness Starkey to be persuasive that ICG purchases and deploys fully functional Lucent 5ESS switches that support multiple switching architectures including line-to-line, line-to-trunk, and trunk-to-trunk. Starkey's testimony is based on discussions with actual ICG switch engineering personnel.⁵⁸ We likewise have no basis to conclude that Pac-West's switches serving ISPs are limited only to trunk-to-trunk capabilities. Verizon witness Jones made no inquiries and did not know either the costs or configuration of Pac-West's facilities.⁵⁹

Witness Wood testified that, in any event, trunk-to-trunk switching costs are non-traffic sensitive and thus, are not part of the costs subject to reciprocal compensation recovery. Witness Starkey also claims the ILECs confuse traffic-sensitive with nontraffic-sensitive costs.

In conclusion, we find no basis to conclude that ISP traffic-sensitive termination costs are uniquely lower due to the use of trunk-to-trunk switching.

**e) Lack of Line Concentration using
ISDN-PRI**

⁵⁸ Exh. 2, (ICG/Starkey) at 13.

⁵⁹ Tr. 1609-12 (Verizon/Jones).

(1) Parties Positions

Verizon argues that CLECs' use of ISDN-PRI technology results in a difference in line concentration accommodated by the switch for ISP calls compared to voice-grade calls. For local traffic terminated to a customer over a standard voice-grade line port, there is typically a line concentration ratio of six to one. This means that the number of standard local POTS lines coming into the switch will be six times greater than the available number of paths through the switch for such traffic. Rather than having a dedicated amount of capacity through the switch, the lines share the switch path capacity at a ratio of six lines to one path.

This six-to-one line concentration configuration works well for standard POTS traffic because each POTS line is generally only used for short periods of time, and all lines are not typically in use at the same time. Because the volume of traffic over each POTS line is relatively low, the lines can efficiently share paths through the switch without substantial amounts of call blocking (a call is blocked when it does not make it through terminating switch because there is no available path). For calls to POTS customers, the switch module – a piece of peripheral equipment that is part of the switch – performs the line concentration function. This function allows the larger number of end-user lines to share the smaller number of paths through the switch. Because the paths through the switch are shared among multiple lines, the use of the switch during the peak hour imposes congestion costs on other line-concentrated users in the form of call blocking or rationing. Call blocking or rationing occurs as a result of the available path being in use. These congestion costs are the busy hour line costs, measured in cenum call seconds (CCS).

As explained by Verizon witness Collins, the busy hour line CCS provides a measure of costs that are caused by the line concentration

accommodated in the switch. Because these busy hour line CCS congestion costs vary based on the volume of the traffic flowing through the available shared switch pathways at a given time, costing models treat these termination costs as traffic-sensitive.⁶⁰ Therefore, where reciprocal compensation applies, such costs are included in any reciprocal compensation charge that the originating carrier must pay to the terminating carrier on a per-minute or per-call basis.

For calls to ISPs over ISDN-PRI connections, Verizon argues however, the situation is very different. When ISP-bound traffic is carried over higher-volume ISDN-PRI trunks, the ratio of incoming to outgoing traffic through the switch is one-to-one. That is, each incoming line (or trunk in the case of traffic that has already gone through a separate originating switch) has dedicated capacity (i.e., a guaranteed path) through the switch. Unlike local POTS traffic, the incoming line does not share that capacity with other traffic. This arrangement is used for ISP-bound traffic because such traffic tends to be higher in volume.

Verizon argues that because the switch reserves dedicated capacity for the traffic that flows over that connection, there is no line concentration and no competition with other non-dedicated traffic for available pathways through the switch. Verizon claims because the ISP that is receiving the call over a PRI connection does not have to compete with other customers for switch capacity, the ISP imposes no congestion costs on the switch as a result of the amount of traffic that is carried to it over the connection.⁶¹ From the perspective of the terminating carrier, it does not matter how frequently the ISP is

⁶⁰ Exh. 154 (Verizon/Collins) at 4.

⁶¹ *Id.* at 5.

constantly using its dedicated capacity. In any case, the number of pathways through the switch available to other customers remains the same.

Verizon claims that this difference in the manner in which the switch paths are allocated reduces the traffic-sensitive costs incurred by the terminating carrier. That is because the level at which the ISP uses its dedicated capacity – i.e., the amount of traffic received by the ISP through the switch – does not affect the congestion in the switch. As a result, Verizon claims the CLEC does not incur traffic-sensitive busy hour line CCS costs when it terminates ISP-bound traffic.⁶² Since only traffic-sensitive termination costs are eligible for recovery by the terminating carrier, the line CCS costs that have been included in the reciprocal compensation rate for line-concentration, Verizon claims that standard voice traffic must be removed from the rate when ISP-bound traffic is at issue.⁶³

Verizon argues that the lack of line concentration performed by the switch on ISP-bound traffic delivered using ISDN-PRI technology results in significantly lower traffic-sensitive switching costs being incurred by the CLEC for termination of traffic.

The CLECs dispute Verizon's claims. Focal witness TerKeurst denies that the switching of a dial-up call onto an ISDN-PRI connection is any less expensive than switching a voice call onto a separate voice circuit. TerKeurst testified that many customers utilize ISDN connections for voice traffic without conversion to analog signals, so that this aspect of the switching process is not unique to ISP-bound traffic.⁶⁴

⁶² *Id.*; Exh. 138 (Verizon/Jones) at 15-16.

⁶³ Exh. 154 (Verizon/Collins) at 5.

⁶⁴ Exh. 61 (Focal/TerKeurst) at 40.

CISPA witness Montgomery testified that, if anything, the ISDN-PRI service used to terminate some ISP-bound traffic is actually more costly, when compared to the termination cost for analog traffic. Montgomery attributes this to two factors: (i) providing ISDN-PRI service requires that additional software be activated in the central switch processor; (ii) that the functionality of ISDN service is more taxing to the central switch processor.⁶⁵

As Focal witness Terkeurst similarly noted the fact that circuits are concentrated within a single ISDN-PRI loop does not reduce the switching requirements. ISDN-PRI connections and the ability to switch digital traffic onto such connections without conversion to analog are not unique to ISP-bound traffic, but are available to any business customer wishing to purchase them. In fact, a number of incumbent LEC business customers purchase such connections.⁶⁶

ICG witness Starkey similarly testified that Verizon's claims of lower cost due to line concentration differences were unfounded and reflected a misperception of the manner in which traffic-sensitive costs are incurred.

(2) Discussion

We find no basis to conclude that CLECs avoid traffic-sensitive switching costs merely because of "dedicated" capacity assigned to ISP incoming calls. While we recognize that ISP call termination may be provisioned over ISDN PRI circuits which utilize higher line concentration than voice traffic, we find that the use of such circuits is not unique to ISPs. Moreover, we find no basis to

⁶⁵ Exh. 109 (CISPA/Montgomery) at 36-38.

⁶⁶ Exh. 61 (Focal/TerKeurst) at 14.

distinguish the use of switching resources used by ISDN circuits from other circuits.

ICG witness Starkey testified that even though ISDN circuits may be provisioned with 1:1 concentration ratios, they share the same finite switching resources (i.e., internal transport links, the switch fabric and the processor), as do other circuits. ISDN circuits are allocated switching resources as calls are made, regardless of the concentration ratio to which they've been engineered. The only difference between an ISDN circuit engineered with a 1:1 concentration ratio versus a more concentrated circuit is the level of priority in the process of allocating switching resources in "real-time." While this may impact which circuits experience "blocking" (i.e., no time slots available), these switched services still consume usage sensitive resources. Starkey's testimony indicated that the switch's processor actually requires more time to process a call delivered via ISDN compared with other types of more traditional traffic.⁶⁷ Based on this testimony, we thus conclude that ISDN-PRI services, regardless of concentration ratio, use traffic-sensitive switch resources (i.e., internal transport links, timeslot management resources and switch processing time), and incur related costs. Therefore, based on the testimony of ICG, Focal, and CISPAs as noted above, we find insufficient basis to accept Verizon's claim that CLECs incur lower traffic-sensitive termination costs as a result of line concentration differences that apply only to ISP traffic.

⁶⁷ Exh. 2 (ICG/Starkey) at 27.

D. Does the Payment of ISP Reciprocal Compensation Result in Unrecoverable Losses to the ILECs?

1. Parties' Positions

Pacific claims that its current retail rate structure precludes recovery of ISP reciprocal compensation payments from its own end use customers at least for those that are billed a fixed monthly rate with unlimited local calling. Pacific argues that the vast majority of its customers calling the Internet have flat rate (1 FR) service, and do not generate any additional revenue to cover the per-minute of use charges paid by Pacific for ISP reciprocal compensation. Pacific claims the price for flat rate residential service does not cover the cost of the access line, much less the additional costs generated by usage-sensitive reciprocal compensation payments.

Witness Jacobsen testified that when the average Internet user uses a dial-up connection for an hour a day (just over the average usage reported by AOL), the LEC originating calls for that customer must pay about \$3.79 per month in reciprocal compensation payments.⁶⁸ However, Pacific argues, the Commission has set the price of flat-rate residential service below either the direct embedded cost or incremental cost of the line.⁶⁹ In fact, the Commission set the price of residential flat service (1FR) at only one half of the fully allocated cost less the End User Common Line ("EUCL") charge.⁷⁰ Thus, Pacific claims that its 1FR service is priced below its forward-looking costs, even without any usage.⁷¹

⁶⁸ Exh. 15 (Pacific/Jacobsen), pp. 12-13.

⁶⁹ D.94-09-065, *mimeo.*, pp. 44-46; see also Exh. 110 (CISPA/Montgomery), p. 10.

⁷⁰ Exh. 106 (Mr. Scholl for Pacific), p. 25.

⁷¹ D.94-09-065, *mimeo.*, pp. 44-46; see also Exh. 110 (CISPA/Montgomery), p. 10.

While most customers use residential flat-rate service for dial-up access to the Internet,⁷² Pacific claims it has receives no additional revenue from 1FR service if that customer uses the service for Internet traffic. Pacific argues that an increase in basic service prices to cover reciprocal compensation payments would unfairly shift the burden of these payments to all customers, whether or not they access the Internet. Pacific claims a rate increase of \$0.60 per month would be required to fund ISP reciprocal compensation payments to CLECs in the year 2000, increasing to \$1.80 per month in the year 2002 based on its assumed growth rates.

Pacific's witness Jacobsen reports that Pacific paid \$173 million in ISP-related reciprocal compensation to CLECs during 1996 through 1999. In the year 2000, Jacobsen reports a drop in such payments to \$135 million. Yet, by the year 2002, Jacobsen projected a growth in payments to \$450 million, based on an assumed compounded growth rate of 5% per month.⁷³

Verizon likewise claims that it has been incurring massive net losses as a result of the Commission's reciprocal compensation rules. Based upon on billing records for the period of November 1, 1998 through May 24, 2000, CLECs have billed Verizon approximately \$32.4 million for reciprocal compensation while Verizon has billed the same CLECs only about \$0.4 million.⁷⁴ Based upon the average hold times for the traffic flowing in each direction, Verizon estimates that

⁷² Exh. 106 (Pacific/Scholl), p. 27. Focal notes that "[e]xcept for the smallest business customers, non-residential customers presumably do not use dial-up ISP access, but rather a higher capacity service such as T-1." Reply Comments of Focal Communications, p. 7, n.14.

⁷³ Exh. 15 (Pacific/Jacobsen) at 13-14.

⁷⁴ Exh. 78 (Verizon/Beauvais) at 29-30.

approximately \$27.1 million of the payments it made to CLECs were for ISP-bound traffic while less than \$200,000 of the payments CLECs made to Verizon were for ISP-bound traffic.⁷⁵ As a result Verizon claims a net loss over that time period of approximately \$27 million.⁷⁶

Verizon claims it cannot recover its reciprocal compensation costs attributable to ISP-bound traffic from the flat rate it charges to the typical residential end-user. Verizon is presently allowed to charge flat rate, one-party residential customers--the customers most likely to access the Internet--\$17.25 per month. Verizon claims the reciprocal compensation for ISP traffic can easily consume half of the total monthly revenue from the end user. After deducting the other costs that must be recovered from the end user revenues, Verizon argues that it cannot recover its payments for ISP reciprocal compensation.

Roseville also claims that it will suffer significant financial hardship from the payment of ISP-related reciprocal compensation. Roseville reports it has 5,400 trunks connected with CLECs of which 99% of the traffic is ISP bound. Roseville estimates that its reciprocal compensation payments to CLECs in 1999 would have been approximately \$1.2 million if it had to pay all CLECs with which it is interconnected based on the rate of \$.002 per minute. Roseville projects growth in this amount to \$2 million in 2000 and over \$2.6 million in 2001. For a company with 1999 intrastate revenues of only about \$94 million, Roseville argues that these amounts are significant. On the other hand, Roseville projects receipts of reciprocal compensation from CLECs of only \$11,000, \$19,000, and \$25,000 for 1999, 2000, and 2001, respectively. While Roseville's monthly service charge is

⁷⁵ Id.

⁷⁶ Id. at 30.

only \$18.90, Roseville argues that it would have to pay reciprocal compensation of \$21.60 for a customer that accessed the Internet for six hours per day. Roseville also reports it has spent \$6.2 million to upgrade its central offices to accommodate the volume of ISP traffic.

The CLECs, CISP, and TURN discount ILEC claims that they are losing money as a result of ISP reciprocal compensation payments. The CLECs claim that the ILECs derive substantial additional revenue from end user customers placing calls to ISPs through the offering of services such as Caller ID, Call Waiting, and Call Forwarding. ICG argues that Pacific's argument that it is losing money on residential customers is contradicted by its own behavior in providing customers a monetary incentive not to disconnect additional lines.

ICG also argues that the rate of growth in ISP terminated minutes will substantially abate due to (1) growth in DSL lines which are not subject to reciprocal compensation and which are most likely to be ordered by those customers with the heaviest Internet access. Likewise, ICG points to Pacific's and Verizon's aggressive deployment of other service alternatives to ISP dial-up access (such as dial-to-frame, virtual point of presence, and CyberPOP services) that will reduce the volume of dial-up ISP usage. Further, ICG notes that ILECs which own ISP affiliates have the capability to compete for increasingly larger shares of Internet business.

TURN likewise argues that far from being a financial drain to ILECs, the Internet provides enormous potential for the ILECs to tap vast new sources of revenue. Pacific, Verizon and Roseville, either directly or through their affiliates,

are all actively marketing Internet service to ISPs and to end user customers.⁷⁷ Pacific's affiliate, Pacific Bell Internet Service, purchases services from Pacific. From 1996 through 1999, the yearly revenues of Pacific Bell Internet Service have grown almost ninefold and the number of subscribers has grown almost fivefold.⁷⁸ Pacific's parent SBC is engaged in a comprehensive refurbishment of its network to facilitate the provision of Internet and broadband services, and to achieve a substantial share of broadband market penetration.⁷⁹ In addition to pursuing significant broadband market share, SBC/Pacific has "conservatively targeted . . . annual savings of about 1.5 billion -- 850 million in cash operating expenses, and 600 million in capital expenditures by 2004" from its broadband initiative.⁸⁰

The CLECs also dispute the ILECs' cost shortfall claims by arguing that the ILECs would incur the costs of terminating the ISP calls themselves if CLECs did not terminate it. The CLECs argue that the payment of reciprocal compensation is equitable because the ILEC thereby avoids the cost of terminating ISP traffic. Since the TELRIC cost is the same whether the ILEC or the CLEC terminates the call, the CLECs claim the ILEC should be indifferent as to whether termination is done by a CLEC or an ILEC.

The ILECs respond by arguing that they incur additional transport expense when delivering traffic to CLECs, as compared to keeping all traffic on

⁷⁷ (Tr. 93, l. 6-14, Tr. 140, l. 5-15, Roseville/Gierczak; Tr. 715, l. 1 - 8, Tr. 716, l. 16-19, Verizon/Beauvais) (Tr. 93, l. 6-14, Tr. 140, l. 5-15, Roseville/Gierczak; Tr. 715, l. 1 - 8, Tr. 716, l. 16-19, Verizon/Beauvais).

⁷⁸ (Exh. 46, Tr. 412, l. 12- 22, Pacific/Jacobsen).

⁷⁹ (Exh. 50, PBRC 04828; Tr. 442, l. 9-24, Pacific/Jacobsen).

⁸⁰ (Exh. 50, PBRC 04827; Tr. 439, l. 6-22, Pacific/Jacobsen).

their own network. Specifically, Pacific witness Hamilton asserts that Pacific Bell bears the vast majority of the network burden to support ISP-bound calls, since competitive LECs may have only one or two points of interconnection in a LATA and Pacific must transport a call a significant distance before handing it off to the competitive LEC. Pacific witness Scholl testified similarly and contends, as a result, that ISP-bound calls delivered to competitive LECs cost Pacific more, not less, to deliver than it would cost Pacific to deliver ISP-bound local traffic to ISPs on its own network.⁸¹

Focal argues that this argument does not apply to its own network. For example, as indicated by Focal witness Tatak, Focal has at least 45 physical points of interconnection with Pacific in the two LATAs in California where it operates.⁸² However, even in the case of a CLEC which has fewer points of interconnection, the ILECs offer no evidence that there is something peculiar to ISP traffic that causes a disproportionate burden on the ILECs' transport burden.

Focal further argues that the average per minute rate paid out by ILECs has been decreasing since 1996, and will continue to decrease due to the re-negotiation of interconnection agreements. Focal claims Pacific's two-part compensation rate ensures that the originating carrier only pays for service they are receiving from the terminating carrier, with no over-recovery. Pacific responds that the growth of the Internet market has created a growing burden of payments that is unsustainable at any compensation rate.

⁸¹ E.g., Reply Testimony of Pacific witness Scholl (Exh. 108) at p. 26.

⁸² Rebuttal Testimony of Focal witness Tatak (Exh. 84) at p. 4.

2. Discussion

We recognize that the ILECs incur significant costs to make reciprocal compensation payments to CLECs. Yet, even to the extent that some losses arguably might accrue to an ILEC as a result of paying reciprocal compensation for ISP traffic, that fact would not, in itself, justify the ILEC withholding reciprocal compensation payments otherwise due for services performed. Financial loss is not a valid basis for any carrier to justify withholding payment for any services performed for its benefit by a third party. Moreover, a fundamental principle underlying the New Regulatory Framework (NRF) established by this Commission was that ILECs were to bear financial responsibility for the business risks that future events would not turn out exactly as expected or as wished. In return, the ILECs gained new opportunities to enhance investor earnings by pursuing new business ventures with profit potential. Pacific's Project Pronto is but one example of such a potential opportunity.

Project Pronto (as described in Exhibit 50, SBC's Investor Briefing) is a \$6 billion "Sweeping Broadband Initiative" investment program.⁸³ Project Pronto promises, for SBC as a whole, "annual savings of \$1.5 billion by 2004," "capital and expense savings [that] pay for [the] initiative on [a net present value ("NPV")] basis, "\$3.5 billion in new revenue by 2004," a "100 basis-point improvement in annual revenue growth," and "significant value creation, well in excess of \$10 billion NPV."⁸⁴ The Investor Briefing states, "SBC's new network investments will have a profound impact on its cost structure; in fact, the efficiencies SBC expects

⁸³ The expectations for Project Pronto are backed by extensive research and analysis, as can be seen in such documents as Exhibits 51-C, 52-C and 53-C. These documents explain the basis on which SBC elected to go forward with Project Pronto.

⁸⁴ Exh. 50, p. PBRC 04822.

to gain will pay for the cost of the deployment on a NPV basis. These efficiencies are conservatively targeted to yield annual savings of about \$1.5 billion by 2004 (\$850 million in cash operating expense and \$600 million in capital expenditures).⁸⁵ Pacific's witness Mr. Jacobsen stated that he saw "Project Pronto as an attempt to live out th[e] new [NRF] framework."⁸⁶

Pacific argues that Project Pronto is not relevant in determining whether Pacific has sufficient revenues to fund ISP-related reciprocal compensation. Witness Jacobsen testified that, "It would be inappropriate [for Pacific] to make decisions now based on cost savings that we're going to hopefully reap in the future. . . . It would be very premature for the Commission to say, Gee, if these materialize, you might be in a position to fund a windfall to your competitors."⁸⁷ Jacobsen also testified that the statements in the Investor Briefing "are projections based upon a lot of assumptions and a lot of hopes. I don't think you can say for sure that these are going to come to pass."⁸⁸ Pacific witness Hamilton clarified that the voice over ATM (VoATM), also known as "voice trunking over ATM" ("VTOA") portion of Project Pronto was currently on hold for several reasons.⁸⁹

We recognize there are business uncertainties associated with Project Pronto as testified to by witness Jacobsen. Yet, irrespective of any specific benefits

⁸⁵ *Id.* at p. PBRC 04827.

⁸⁶ Tr. at 440/13-14.

⁸⁷ Tr. at 441/15-17, 24-26.

⁸⁸ Tr. at 439/26-28.

⁸⁹ Tr. at 1535/19-28.

that may ultimately be realized from Project Pronto, the relevant issue is that Project Pronto represents an example of the structure of risk and reward incentives under NRF. The presence of reciprocal compensation gives Pacific and SBC an incentive to achieve as many cost savings and efficiencies as possible through ventures such as Project Pronto.

Moreover, Exhibit 164 indicates, in Verizon's response to ICG's Data Request No. 13, that GTEC is currently generating \$55.5 million from advanced technology products and services that GTEC has developed or deployed to serve ISPs. See also, Exhibit 167 (showing Verizon's 1999 revenues of \$16.8 million from local exchange dial tone access line services (\$35.39/line) sold to ISPs). None of this revenue, of course, existed at the time of the IRD decision in 1994, and none of the incremental profits associated with the sale of these Category II services will cause any adjustment of the rates that GTEC charges for its other services. In claiming that they have no sources of revenue to offset reciprocal compensation payments to CLECs (*see, e.g.,* Exh. 15, p. 24, ll. 7-9 (Mr. Jacobsen for Pacific)), the ILECs fail to recognize the potential for such new revenue sources.

The reciprocal compensation obligation thus provides incentives for the ILECs to seek to win over ISP customers and aggressively market alternatives to dial-up access to ISPs. By doing so, the ILECs can minimize their reciprocal obligation burden by migrating customers off dial-up access.

The fact that CLECs have been more aggressive in marketing their services to ISPs and have achieved a much greater than anticipated share of the ISP market does not justify insulating the ILECs against the risk resulting from such an unexpected outcome. Notwithstanding our misgivings with the underlying premise of this particular line of argument, we find no substantive basis in the ILEC's claims of significant financial loss due to payment of reciprocal compensation to CLECs.

The beginning point for Pacific's argument is that 1FR revenues already fail to recover costs even before consideration of reciprocal compensation revenue. We find that Pacific's narrow focus only on 1FR revenues to the exclusion of other revenue sources runs contrary to the stated intent of the Implementation Rate Design (IRD) proceeding which took into account that various revenue sources would provide differing levels of profit contribution. Pacific witness Scholl conceded that IRD intended that toll services priced above cost were to be recognized as an offsetting contribution to cover any shortfalls in 1FR cost recovery.⁹⁰

Moreover, we find no basis to conclude that an incremental call duration of ISP calls results in a significant financial harm to Pacific. Dr. Selwyn testified that the "ILECs' existing retail local exchange tariffs are generally set at sufficiently high levels to compensate for most, if indeed not all, of the ILEC's usage costs associated with local dial-up calls to ISPs."⁹¹ Dr. Selwyn provided an example of a California subscriber to America On-Line's ("AOL") Internet service who connects to AOL through a second residential exchange line obtained from Pacific. Assuming the subscriber's AOL usage is 64 minutes a day (i.e., 32 hours per month) and average per-call duration is 30 minutes, Selwyn calculated the total incremental costs of the associated local telephone usage. Selwyn used Pacific's most recently approved TSLRICs for local usage. Selwyn further compared such costs to the total local usage component implicit in Pacific's residential flat-rate charge and concluded that Pacific's local usage rate component

⁹⁰ See Tr. at 372-73 (Pacific/Scholl)

⁹¹ See Exh. 127 at 14 (Pac-West Witness Selwyn Direct Testimony).

“more than compensates Pacific for the incremental costs of that customer’s dial-up ISP calls.”⁹²

When the Commission last conducted its comprehensive review of Pacific’s local residential rates in its 1994 IRD proceeding, it purposely set such rates at one-half of Pacific’s reported *fully allocated* costs. Such rates, however, consisting of direct embedded, or historical, costs plus an allocation of common overhead costs⁹³ are unlikely to be below Pacific’s long-run incremental costs of carrying local traffic based on forward-looking technologies. Thus, Pacific’s arguments fail to provide a cost basis against which to evaluate whether current revenues recover its forward looking costs of providing IFR service today.

None of the ILECs’ data showing growth in Internet usage prove that such usage has significantly affected their cost assumptions made when they established their residential rates. As Dr. Selwyn testified, available FCC data “demonstrate[s] that the Internet has had a significant impact upon the demand for additional residential access lines, but has had little impact upon the *average volume of local traffic* carried over each line.”⁹⁴ Beginning in 1990, “the demand for additional residential access lines began to mushroom, and by the end of 1998 . . . over one-fifth of all U.S. households had an additional residence line, representing some 20.4-million such lines nationwide.”⁹⁵ “During that same period, the per-line volume of local calling increased by only 19 percent.”⁹⁶

⁹² *Id.*

⁹³ See D.94-09-065, mimeo at 5, 32-33, 45-46 (Sept. 15, 1994).

⁹⁴ See Exh. 127 (Pac-West/Selwyn) at 15.

⁹⁵ *Id.*

⁹⁶ *Id.*

Pacific's own data, shows that Internet usage has only resulted in an average duration increase for all of its local traffic from 2.25 minutes to 2.47 minutes in 1999, an increase of only 0.22 minute. The average overall duration of 2.47 minutes for local calls, including ISP calls, is still less than the 3 minutes which Pacific acknowledges is the average local call duration assumption underlying Pacific's local service rates set in the 1994 IRD proceeding.⁹⁷ We also find no basis to support Pacific's estimates of growth in the rate of its payments for ISP-related reciprocal compensation through the year 2002. In fact, through its own marketing efforts to promote alternative Internet access services such as Digital Subscriber Line (DSL), Pacific has the potential to actually reduce the magnitude of such reciprocal compensation payments to CLECs going forward.

Roseville raises the additional issue of its financial burden for new plant upgrades to accommodate interconnection with CLECs. While the \$6.2 million investment reported by Roseville may be significant in magnitude, such costs are byproduct of CLEC interconnection generally, and are not uniquely limited only to ISP-bound traffic. Thus, the fact that Roseville may incur network upgrades as part of its general obligation to facilitate competition in its service territory is not a reason to withhold reciprocal compensation payments for the termination of traffic by CLECs, including that of ISPs. Whatever means may be appropriate for Roseville to recover its plant upgrade costs, the elimination of its reciprocal compensation obligations is not the proper remedy.

In any event, any claims of ILECs regarding the need to raise end user retail rates to fund reciprocal compensation payments are beyond the scope of this phase of the proceeding. Thus, the record provides no basis to conclude that

⁹⁷ See Tr. At 348-49 (Pacific Witness Jacobsen).

the impacts of Internet usage has adversely affected the ILECs' overall financial health.

VII. Is Bill-And-Keep a Reasonable Alternative for Reciprocal Compensation?

A. Parties' Positions

The ILECs propose that reciprocal compensation be eliminated for ISP traffic and replaced with a "bill-and-keep" approach to compensation. Under bill-and-keep, the ILEC would continue to absorb costs to originate and transport ISP-bound traffic to CLECs, and would receive no compensation from CLECs or its customers for such origination, transport, and switching costs. CLECs would continue to bill ISPs, and CLECs would retain all of these revenues. CLECs would not pay Pacific for the additional switching and transport costs of ISP-bound calls.

The ILECs claim that bill-and-keep provides for an equitable sharing of the burden of the FCC's exemption of ISPs from paying access charges. As a result of this exemption, neither originating nor terminating carriers can levy access charges on ISPs. Pacific argues that if the ISP exemption were not in place, carriers would be compensated by a meet-point-billing arrangement with access charges applying on both the originating and terminating side of the call. Pacific characterizes its proposal as a continuation of the meet-point-billing requirements, but with the exemption of the ISP from access charges, resulting in a "bill-and-keep" arrangement whereby the originating and terminating carrier each shoulders the burden for the portion of the call they carry.⁹⁸

Pacific points to various purported advantages to end users of bill-and-keep. End-user customers would not have to pay toll charges to access the

⁹⁸ Exh. 15 (Pacific/Jacobsen) at 25-26.

Internet. CLECs would continue to have calls rated as local and at the same time have the calls routed to distant points of interconnection without paying Pacific for transport and tandem switching.

End-user customers would not have to provide additional funding to Pacific, or any other originating carrier, to finance reciprocal compensation payments CLECs.

Pacific also claims a level playing field would be created in the market place for ISP business. All LECs serving ISPs would use ISP revenues to cover their costs. Consistent with the FCC's ESP exemption, LEC costs that are not covered by charges to ISPs would be absorbed. LECs would not view residential customers as potential liabilities.

Pacific's witness, Dr. Harris, characterized bill-and-keep as "a reasonable compromise halfway between the long distance access charge scheme which would flow revenue back to PacBell, the originating carrier, and the current reciprocal compensation scheme which flows charges from PacBell to the CLEC serving an ISP." Dr. Harris testified that bill and keep would reduce the distortion that favors old-fashioned dial-up modems over advanced access technologies. Pacific still believes the adoption of bill and keep for ISP-routed traffic represents a subsidy from Pacific to the ISP because there is no intercarrier compensation, rather than having the ISP compensate the ISP's LEC/CLEC and Pacific Bell. Pacific claims that CLECs can cover (or already are covering) their switching costs by charges already levied on ISPs without reciprocal compensation payments from Pacific.

Pacific believes that under the Act, bill-and-keep arrangements are acceptable outcomes. Pacific argues that because Sections 251 and 252 do not mandate that reciprocal compensation be paid on ISP-bound calls; the Commission has the latitude to adopt a preferred outcome excluding ISP-bound calls from reciprocal compensation requirements. Since the FCC has exempted

ISPs from paying carrier access charges, Pacific argues that costs need to be recovered from the users of the respective carrier services - ILECs from their end users and CLECs from their end users, including ISPs. Pacific claims that nothing in the law prohibits CLECs from recovering costs from ISPs through fees other than access charges.

The ILECs argue that the elimination of reciprocal compensation payments will merely eliminate certain CLECs' windfall profits, but deny that there is any evidence that the CLECs' financial viability would be threatened. Pacific points to statements made by ICG and Focal to investors and the financial community to the effect that they will be viable even without the reciprocal compensation they currently receive.

CLECs oppose the bill and keep alternative, arguing that it would prevent recovery of terminating costs from the originating caller that causes the costs to be incurred. CLECs argue that because the originating caller initiates the call to the ISP, the carrier of the originating caller should compensate for the cost of terminating the call to the ISP as a matter of economic fairness. Witness Selwyn argues that all local calls are undertaken on a "sent-paid" basis whereby the originating subscriber has paid to have the call delivered on an end-to-end basis.

The CLECs argue that bill and keep is particularly inappropriate due to the traffic imbalance in ISP-bound calls exchanged between competitive LECs and incumbent LECs. Focal argues that the traffic imbalance is precisely the reason why reciprocal compensation is needed. Adoption of bill-and-keep (the default arrangement if reciprocal compensation payments are eliminated) when traffic is not roughly balanced would preclude the LEC with the greatest volume of terminating traffic from recovering its transport and termination costs. Imposition of a bill-and-keep mechanism when traffic is imbalanced would be inconsistent with the FCC's rules on the matter. Specifically, the FCC concluded that bill-and-

keep may only be imposed by state commissions where the traffic terminated on interconnecting LECs' networks is roughly equal and is expected to remain so.

B. Discussion

We do not find the bill-and-keep proposal to provide an equitable alternative to reciprocal compensation. The ILECs propose the bill-and-keep mechanism as a remedy for the perceived imbalance in the flow of services and revenues that they claim currently exists. The bill-and-keep mechanism would relieve the ILECs from paying any reciprocal compensation for any calls their customers make to ISPs that are terminated by CLECs. Yet, the bill-and-keep alternative does nothing to move toward a more balanced flow of services and revenues related to ISP call termination. If anything, the bill-and-keep alternative would result in an equal if not greater asymmetry than that presently alleged by the ILECs. Under present policies, there is a matching of reciprocal compensation revenues with minutes of traffic terminated to ISPs, whether by an ILEC or a CLEC. The bill-and-keep proposal would eliminate this matching.

Verizon argues that bill-and-keep is a competitively fair outcome because it treats both ILECs and CLECs equally by exempting them all LECs from paying any compensation to any other LEC. Verizon's argument is one-sided, however, by failing to consider the imbalance in terms of services rendered. The proposal would not treat ILECs and CLECs equally in relation to the volume of ISP traffic they are required to terminate. To the extent that CLECs terminate disproportionately much greater ISP traffic volumes than do ILECs, the adoption of bill and keep would disproportionately penalize the CLECs. The bill and keep alternative would create a significant asymmetrical distortion between (1) the service rendered in terminating ISP calls, and (2) the payment made for that service.

ILECs argue that the prohibition on using bill and keep when traffic flows are out of balance only applies for "local" traffic. Assuming the Commission chooses to classify ISP traffic as non-local, the ILECs argue, there is no prohibition on applying the bill-and-keep approach. Even assuming the FCC technical prohibition did not apply, the ILECs still fail to justify why the underlying rationale for requiring a rough balance of traffic flows would not apply to ISP traffic to justify bill-and-keep even if the traffic is technically deemed non-local.

Pacific also seeks to justify its proposal on the basis that the ISP and its subscriber are the primary cost causer whenever a customer of the ISP originates a call over an ILEC local phone line to reach the ISP. Pacific witness Harris first argues that from a cost-causation perspective, it is the responsibility of the ISP and its subscriber to ensure that all of the suppliers are paid for in their roles in providing the ISP's service. The subscriber contracts with an ISP that, in supplying that service, uses the PSTN. The fact that the ISP subscriber also is the subscriber to local exchange service from the ILEC is not relevant under Harris' theory. Harris claims that because the ISP is acting on behalf of the subscriber to route the subscriber's traffic to the Internet, the situation is very different from others involving what he calls "true" local end-users.

We find Harris' attempt to define the ISP as the cost causer to be inconsistent with the principles linking payment obligation with cost causation for other types of calls. Harris seeks to justify the inconsistency by claiming a unique relationship exists between the ISP and its subscriber in comparison to other types of "true" local end users. We find that no essential difference between the ISP and its subscriber that justifies an inconsistent application of cost-causation principles compared with other types of calls. As noted by witness Selwyn in rebuttal testimony, there are any number of non-ISP businesses and service providers for which the telephone call placed by the end user is an indispensable aspect of the